Office of Chief Counsel
Internal Revenue Service

memorandum

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GEGabriel

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to: Larry I. Walter
National Inventory Issue Specialist

from: Grant E. Gabriel
National Inventory Issue Specialist Counsel

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subject: [redacted]
IRC § 351 Transfer of LIFO Inventories

This memorandum responds to your request for assistance regarding the above-referenced case. Specifically, you requested us to opine to what extent the transferor's historical last-in, first-out (LIFO) inventory layers, transferred as part of an IRC § 351 transaction, carryover to the transferee. The advice in this memorandum is subject to post-review in the National Office. Accordingly, please do not share this advice with the exam team until we receive National Office validation.

DISCLOSURE STATEMENT

This advice constitutes return information subject to IRC § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

ISSUE

Under the circumstances described below, to what extent does transferee carry-over transferor's LIFO inventory layers and integrate these layers into transferee's own LIFO layers?

CONCLUSION

Transferor1's layers transferred to Transferee (a newly-formed subsidiary that elects the LIFO method) will be collapsed and become Transferee's opening inventory and will be valued at average cost . Because Transferor2's [redacted] and [redacted] LIFO layers pre-date transferee's taxable year of existence, these layers are "collapsed" into the already collapsed layer representing Transferee's opening inventory and are also valued at average cost. Only the common [redacted] LIFO layers of Transferor2 and Transferee are integrated.

FACTS

Transferor1, Transferor2 and Transferee3 are all processors of similar consumer products. At the beginning of taxable year [redacted] Transferee, a newly established subsidiary that adopts the LIFO method receives all of the LIFO inventory of Transferor1 in an IRC § 351 transfer. Transferor1's LIFO history consists of [redacted] and [redacted] layers. During taxable year [redacted] Transferee incurs a LIFO increment for its single inventory pool of Product X. At the beginning of taxable year [redacted] Transferee (now an existing LIFO subsidiary) receives all of the dollar-value LIFO inventory of Transferor2 in an IRC § 351 transfer. Transferor2's entire inventory consists of increments for [redacted] and [redacted] Transferee also had an increment for its [redacted] taxable year.

LAW

Section 351(a) of the Code provides that, generally, no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

Section 362(a) provides that the basis of property received by a transferee corporation in a section 351 transaction shall be the same as it would be in the hands of the transferor.

Section 472(a) provides that a taxpayer may use the LIFO inventory method in inventorying goods specified in an application to use such method. The change to, and the use of such method should be in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of such method may clearly reflect income.

Section 472(b)(1) provides that under the LIFO method, goods comprising ending inventory are treated as first being those included in the opening inventory of the taxable year (in the order of acquisition) to the extent thereof; and second, those acquired in the taxable year. Section 472(b)(2) provides that in inventorying goods under the LIFO method, the taxpayer shall inventory them at cost.

Treas. Reg. § 1.472-3(d) provides that whether or not the taxpayer's application for adoption and use of the LIFO inventory method should be approved, and whether or not such method, once adopted, may be continued, and the propriety of all computations incidental to the use of such method, will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns.

Treas. Reg. § 1.472-8(a) provides that any taxpayer may elect to determine the cost of its LIFO inventories under the so-called "dollar-value" LIFO method, provided such method is used consistently and clearly reflects income. The dollar-value method of valuing LIFO inventories is a method of determining cost by using "base-year" cost expressed in terms of total dollars rather than the quantity and price of specific goods as the unit of measurement.

Rev. Rul. 70-564, 1970-2 C.B. 109, holds that a new corporation or an existing corporation not using the LIFO method that acquires inventories from a transferor corporation that uses the LIFO method must file Form 970 to properly adopt the LIFO method. The cost of opening inventory for the year of change is determined as provided by § 472(b)(3) of the Code.

Rev. Rul. 70-565, 1970-2 C.B. 110, holds that the LIFO layers of the transferor's LIFO inventories carry over in an IRC § 351 transaction to an existing transferee also using the LIFO method. The facts in *Rev. Rul. 70-565* indicate that both the transferor and transferee had been in existence for many years prior to the transfer and both had used the LIFO method.

DISCUSSION AND ANALYSIS

Collapsing of Transferor1's LIFO Layers

Rev. Rul. 70-564 holds that a newly-formed transferee that adopts the LIFO method (or an existing subsidiary not using the LIFO method) must file a Form 970 to elect the LIFO method and , if it does so, determines its opening inventory for the year of change by the average cost method. On these facts, Transferor1's [redacted] and [redacted] layers will be collapsed into a single layer valued at average cost in accordance with § 472(b)(3). This single layer valued at average cost becomes Transferee's opening inventory in [redacted]

Collapsing of Transferor2's [redacted] and [redacted] LIFO Layers

Rev. Rul. 70-565 holds that a corporation already using the LIFO inventory method that acquires LIFO inventories in an IRC § 351 transaction must integrate the acquired LIFO layers into **its own** monthly layers[1]. The conclusion in Rev. Rul. 70-565 is based on the Court of Appeals for the Sixth Circuit's holding in *Seagram v. Commissioner*, 394 F.2d 738 (6th Cir. 1968), *reversing* 46 T.C. 698 (1966), that the transferee is required to integrate the transferor's layers into its own. Significantly, in so holding the Court distinguished the case before it from the Tax Court's holding in *Textile Apron Co., Inc. v. Commissioner*, 21 T.C. 147 (1953) (accounting methods and tax attributes do not carry-over to a successor transferee that is a new taxable entity). Specifically, in *Seagram* the Court held the Commissioner was not imposing the transferor's method of accounting on the transferee by requiring the transferee to integrate the transferor's layers into its own in accordance with the transferor's acquisition dates.

We believe the distinction between transfers of LIFO inventory to a newly-formed LIFO subsidiary and transfers to an existing LIFO subsidiary should be narrowly construed and only apply to those layers that would otherwise be capable of being integrated into the transferee's LIFO layers. In other words, the yearly layers that are carried over cannot exceed the number of years that the transferee has been on the LIFO method. This is consistent with the *Seagram* Court's quandary over whether the term "basis" under § 362 should be expanded or whether the term "acquired" under § 472(b)(1) should be restricted to achieve the proper result.

This approach achieves the objective of integrating the transferor's inventory into the transferee's layer system to the extent possible and prevents using average cost to the extent of this commonality. However, for taxable years pre-dating transferee's existence, the transferred layers are best treated as if they were transferred to a newly-formed subsidiary that elects the LIFO method.

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[1]LIFO inventory layers (increments) are properly determined and valued on an annual basis.

On these facts, Transferor2's [redacted] and [redacted] layers all pre-date Transferee's first taxable year of existence, [redacted] Thus, these three layers are all collapsed into Transferee's opening inventory that, up to now, consisted of the [redacted] and [redacted] layers that had been previously collapsed from Transferor1.

Integration of Transferor2's and Transferee's [redacted] Layer

Transfers pursuant to IRC § 351 apply without an election. Moreover, subsequent transfers satisfying the requirements of § 351 are similarly treated (carry-over basis, non-recognition of gain or loss if no "boot"). In the case of LIFO transfers, however, the treatment differs depending on whether the inventory is transferred to a newly-formed subsidiary that elects the LIFO method or whether the inventory is transferred to an existing subsidiary that uses the LIFO method. However, as discussed above, this difference only applies to the extent the transferor and transferee have years in which both entities were using the LIFO method. Thus, in this case, only Tranferor2's and Transferee's [redacted] LIFO layer will be integrated.

GRANT E. GABRIEL
Special Litigation Assistant